

Letter of Findings: 02-20110045
Corporate Income Tax
For the Years 2007 and 2009

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ISSUES

I. Timeliness – Administration.

Authority: IC § 6-8.1-5-1(d).

Taxpayer argues that it is entitled to administrative review of the Department's proposed assessment because its protest was timely.

II. Bad Debt Allowance – Corporate Income Tax.

Authority: IC § 6-3-1-3.5; IC § 6-8.1-5-1(c); IC § 6-8.1-5-4(a), (b); I.R.C. § 166(a); Piggy Bank Stations, Inc. v. Comm'r., 755 F.2d 450 (5th Cir. 1985); Road Materials, Inc. v. Comm'r., 407 F.2d 1121 (7th Cir. 1969); Sowards v. Comm'r., T.C. Memo. 2003-180, 2003 WL 21414855 (U.S. Tax Ct., 2003); Meier v. Comm'r., T.C. Memo. 2003-94, 2003 WL 1700083 (U.S. Tax Ct., 2003); Newman v. Comm'r., T.C. Memo. 2000-345, 2000 WL 1675519 (U.S. Tax Ct., 2000).

Taxpayer maintains that it was entitled to a deduction of "bad debts" claimed on its 2006 federal income tax return.

STATEMENT OF FACTS

Taxpayer is an Indiana company in the construction business. It sells property, leases subsidized apartments, leases commercial buildings, and manages buildings.

Taxpayer files a consolidated return with related entities. The Department of Revenue (Department) conducted an audit of Taxpayer's 2005 and 2006 income tax returns. The audit did not result in the assessment of additional tax. However, the audit disallowed "bad debts" of approximately \$844,000.

Taxpayer subsequently filed 2007 and 2009 Indiana income tax returns "carrying over" the net operating losses attributable to the previously disallowed bad debts. After reviewing those returns, the Department adjusted the 2007 and 2009 returns to reflect the disallowance of the original "bad debts" and the consequent claim of net operating losses.

The adjustment resulted in an assessment of additional income tax for 2007 and 2009. Taxpayer challenged the assessment. An administrative hearing was conducted, additional documentation was provided, and this Letter of Findings results.

I. Timeliness – Administration.

DISCUSSION

The first issue is whether Taxpayer's protest was timely filed with the Department. Taxpayer maintains that the 2007 and 2009 assessment proceeded to the "collection stage" without ever providing Taxpayer the opportunity to protest the initial protest. Taxpayer argues that it submitted a protest as soon as it had notice of the assessment. Taxpayer finds fault with the Department for purportedly failing to provide timely notice of the assessment.

A proposed assessment must be protested within 45 days. IC § 6-8.1-5-1(d) provides as follows:

The notice [of proposed assessment] shall state that the person has forty-five (45) days from the date the notice is mailed, if the notice was mailed before January 1, 2011, and sixty (60) days from the date the notice is mailed, if the notice was mailed after December 31, 2010, to pay the assessment or to file a written protest. If the person files a protest and requires a hearing on the protest, the department shall:

- (1) set the hearing at the department's earliest convenient time; and
- (2) notify the person by United States mail of the time, date, and location of the hearing.

The statute provides that a taxpayer has 45 days from the date of a proposed assessment in which to protest that assessment with the Department.

Given the facts and circumstances as presented, the Department is prepared to agree that Taxpayer challenged the 2007 and 2009 assessment within the statutory 45-day period.

FINDING

Taxpayer's protest is sustained.

II. Bad Debt Allowance – Corporate Income Tax.

DISCUSSION

Taxpayer wrote checks to a related entity hereinafter designated as "Home Builder." Both Taxpayer and Home Builder are wholly owned by Individual. Individual owns, operates, and controls both Home Builder and Taxpayer. Taxpayer explains the origin of the bad debts and the subsequent net operating loss as follows:

[W]hen [Home Builder] required funds, [Individual] would direct funds to be transferred to it. If [Home Builder] ever had any money, he would direct that, that money be transferred back since all these entities were wholly owned by him and under one umbrella of the [Taxpayer]. A consolidated return is filed under federal law for them the ability to move funds in an inter-company fashion was easy.

Taxpayer further explains:

In the year 2006, a substantial loss of \$844,000 was taken as a deduction on the IT-20 of [Taxpayer]. That deduction was with regard to the finalization of all relationships with [Home Builder] which was allowed to be involuntarily dissolved and final returns were filed.

Taxpayer maintains that Home Builder never repaid the \$844,000. The Department's 2005 and 2006 audit – completed October 2008 – reviewed the claimed loss and made an audit assessment "denying the bad debt collected reported on [Taxpayer] and Associates 2006 return."

The audit report states as follows:

The [T]axpayer deducted bad debts of [\$844,000] on [Taxpayer's] 2006 federal return. The [T]axpayer was given adequate time to provide support of this deduction. The only information provided was that the amount represented cash advanced to [Home Builder] over the course of several years which was never paid back. It was determined that the information provided was insufficient to make a determination regarding its classification as a business bad debt that is deductible in determining the taxable income of [Taxpayer]. Without evidence of the actual loan documents, the nature of the loans (business or non-business), the timing of the loans, the reasons for the loans and the attempts made by [Taxpayer] and Associates to collect the amounts due, it is impossible to make an informed determination regarding the deduction.

As a threshold issue, it is the Taxpayer's responsibility to establish that the existing tax assessment is incorrect. As stated in IC § 6-8.1-5-1(c), "The notice of proposed assessment is prima facie evidence that the department's claim for the unpaid tax is valid. The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made." In addition, IC § 6-8.1-5-4(a) and (b) require that each taxpayer maintain books and records sufficient to verify that taxpayer's liability for a listed tax.

(a) Every person subject to a listed tax must keep books and records so that the department can determine the amount, if any, of the person's liability for that tax by reviewing those books and records. The records referred to in this subsection include all source documents necessary to determine the tax, including invoices, register tapes, receipts, and canceled checks.

(b) A person must retain the books and records described in subsection (a), and any state or federal tax return that the person has filed:

- (1) for an unlimited period, if the person fails to file a return or receives notice from the department that the person has filed a suspected fraudulent return, or an unsigned or substantially blank return; or
- (2) in all other cases, for a period of at least three (3) years after the date the final payment of the particular tax liability was due, unless after an audit, the department consents to earlier destruction.

Taxpayer asserts that it claimed an entirely legitimate "bad debt" deduction on its federal returns. In Taxpayer's case, it has provided verifiable copies of numerous checks it wrote to Home Builder but as the original audit report notes, Taxpayer has not provided copies of loan documents or any other document which would establish that Taxpayer had entered into a debtor/creditor relationship with Home Builder. As Taxpayer admits, "[T]here was no written documentation with regard to the transfers in the form of notes, contracts, or credit agreement of any kind." The only records available "are bookkeeping and accounting records which" Taxpayer provided. Taxpayer believes that these bookkeeping and accounting records establish that Taxpayer made loans to Home Builder which were never repaid.

To compute a corporation's Indiana adjusted gross income tax, one begins with the federal adjusted gross income and makes certain adjustments. IC § 6-3-1-3.5. However, a bad debt deduction is not one of the listed adjustments the taxpayer makes to its federal adjusted gross income. The bad debt deduction resides entirely on the federal return. The federal bad debt deduction is found at I.R.C. § 166(a) and applies to a corporation's Indiana adjusted gross income.

In order for Taxpayer to establish that it wrote the checks as "loans" to Home Builder, Taxpayer must demonstrate an intention on the part of both Taxpayer and Home Builder to create a debt, that the Home Builder expected to repay the loans, and that Taxpayer and Home Builder intended to enter into debtor-creditor relationship. "Loans are identified by the mutual understanding between the borrower and lender of the obligation to repay and a bona fide intent on the borrower's part to repay the acquired funds." *Sowards v. Comm'r., T.C. Memo. 2003-180, 2003 WL 21414855 at *9* (U.S. Tax Ct., 2003) (Internal citations omitted). The ultimate question is whether there was a "genuine intention to create a debt, with a reasonable expectation of repayment" and that the intention comported with "the economic reality of creating a debtor-creditor relationship." *Id.* (See also *Meier v. Comm'r., T.C. Memo. 2003-94, 2003 WL 1700083* (U.S. Tax Ct., 2003) Finding that the petitioner bore the burden of proving that the amounts at issue constituted loans and that the loans became worthless.)

Taxpayer must meet a minimum standard for establishing that the money it advanced to Home Builder constituted a loan. For purposes of determining whether parties to a transaction created an obligation to repay the funds advanced the factors may include whether the parties include: "(1) whether the parties intended to create

an unconditional obligation to repay, (2) whether the [borrower] controlled the [lender], (3) whether any security was given, (4) whether there was a maturity date and a specific repayment schedule, and (5) whether the [borrower] had the ability to repay." *Piggy Bank Stations, Inc. v. Comm'r.*, 755 F.2d 450, 453 (5th Cir. 1985).

As the federal Tax Court has held, "With respect to the business bad debt claim, section 166(a) allows a deduction for 'any debt which becomes worthless within the taxable year.' Under Treas. Reg. § 1.166-1(c), the debt must be 'bona fide,' defined as 'a debt which arises from a debtor-creditor relationship based upon a valid and enforceable obligation to pay a fixed or determinable sum of money.'" *Newman v. Comm'r.*, T.C. Memo. 2000-345, 2000 WL 1675519 at *4 (U.S. Tax Ct., 2000). Furthermore, the party claiming the bad debt "must exhaust the usual and reasonable means of collection before they are entitled to a deduction. When efforts to collect become futile, the deduction is allowed." *Id.*

Taxpayer strenuously maintains that the checks written to Home Builder were loans but has provided no contemporaneous evidence establishing that assertion. However, an intention to create a debt "depends upon whether contemporaneous facts, not testimony given years later, establish an unconditional obligation to repay the advances. In litigated cases the issue often is not free from doubt, and decision must be based on analysis of the entire record. This is especially required when the nominal debtor and creditor are controlled by the same person and the arm's length dealing that characterizes the money market is lacking. For this reason, the substance of the transaction is controlling, not the form in which it is cast or described." *Road Materials, Inc. v. Comm'r.*, 407 F.2d 1121, 1124 (7th Cir. 1969) (Emphasis added).

The Department must disagree with Taxpayer's contention it has met its burden of establishing that the proposed assessment is incorrect as required under IC § 6-8.1-5-1(c). Taxpayer failed to demonstrate that it entered into a unconditional loan agreement with Home Builder, that the loan agreement included a "maturity date and specific repayment schedule," that the parties mutually agreed that the amounts would be repaid, that Taxpayer reasonably believed it would be repaid, and that Taxpayer exhausted all reasonable means to collect the debt. Especially because Home Builder and Taxpayer were owned by the same person, Taxpayer bore a specific burden of establishing that the parties dealt with each other at "arms length." *Road Materials* 407 F.2d at 1124.

FINDING

Taxpayer's protest is respectfully denied.

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